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A History of the Arizona Transaction Privilege Tax on Contracting Activity

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1933 – 1959

- April 30, 1933, the Arizona Transaction Privilege Tax (“TPT”) became effective pursuant to Chapter 90, Laws 1933.
- TPT levied on gross proceeds of business activities at varying rates, but contracting was not a listed activity.

1933 – 1959

- In 1937, AZ Supreme Court held that TPT on retail sales applied to the gross proceeds from the activity of contracting (*Moore v. Pleasant Hasler Construction Co,* 50 Ariz. 317, 72 P.2d 573).
- Case was reheard by the AZ Supreme Court and the prior decision was reversed, thereby finding that the TPT did not apply to contracting (51 Ariz. 40, 76 P.2d 225).
- Prior to original decision, the Legislature enacted TPT on contracting activity (Laws 1937, 1st Special Session, Chapter 2). This action formed the basis for the rehearing reversal, as the Court determined that the original act must not have been designed to tax contractors as retailers.

1933 – 1959

- In 1943, Superior Court judgment held that sales of material to a contractor were taxable retail sales.
- Legislature enacted provision which precluded TPT on materials sold to a contractor for incorporation into work constructed under a contract (Laws 1943, Chapter 16).
- Governor vetoed, but Legislature overrode veto.
- AZ Supreme Court declared the act unconstitutional in *Martin v. Moore,* 61 Ariz. 92, 143 P.2d 334, 335.

1933 – 1959

- The AZ Supreme Court determined that a retailer's sales to contractors were nontaxable resales (*Crane Co. v. Arizona State Tax Commission,* 63 Ariz. 426, 163 P.2d 656 (1944)).
- Basis for decision was that contractors were not the ultimate consumers of the property and the placement of materials in structures constituted a resale of that property.

1933 – 1959

- In 1945, the AZ Supreme Court held that sales by a contractor to the federal government were not exempt from tax since the taxpayer was not a retailer and could not qualify for the exemption for sales to the federal government. *Arizona State Tax Commission v. Frank Harmonson Company Metal Products,* 63 Ariz. 452, 163 P.2d 667.
- The Court also held that the Commission could not exempt a taxpayer unless the Legislature gave specific authority to do so.

1933 – 1959

- The *Harmonson* decision was reinforced by *Duhame v. State Tax Commission*, 65 Ariz. 268, 179 P.2d 252, in 1947.
- Court overruled *Crane* and reaffirmed the fact that contractors are not making sales at retail.
- The holdings in these two cases were critical to the State's ability to tax projects with the federal government and impacted the decision in 1984 to change the language in what is now A.R.S. §42-5002(A)(1) to allow tax factoring instead of requiring separate statement of the tax (Laws 1984, Ch. 335). This conformed the treatment of the TPT with the NM gross receipts tax following the U.S. Supreme Court decision in *U.S. v. New Mexico*, 455 U.S. 720, 102 S. Ct. 1373 (1982), which upheld that tax on projects with the federal government.

1933 – 1959

- In 1952, the Legislature enacted a provision to exempt the sales of materials to licensed contractors from the TPT if the materials were incorporated or fabricated into any structure, project, development or improvement in fulfillment of a contract (Laws1952, Ch. 100).
- The requirement that a contractor be licensed to qualify for the materials exemption was eliminated by Laws 1981, Ch. 110.
- The elimination of the requirement to be licensed in order to be eligible for the exemption arose from the fact that persons could be deemed to be taxable contractors under the TPT provisions even if they did not meet the licensing requirements of the Registrar of Contractors.

1933 – 1959

- In 1954, the Legislature changed the scope of the TPT by establishing exclusions for service occupations and created a labor deduction for contracting, which was incorporated in the revision and recodification in 1955 that created the Arizona Revised Statutes and placed TPT into Title 42 (Laws 1955, Third Special Session, Ch. 3).
- The labor deduction was comprised of payments made by the contractor for labor employed in construction, improvements or repairs.

1933 – 1959

- In *Moore v. Smotkin*, 79 Ariz. 77, 283 P.2d 1029 (rehearing 79 Ariz. 401, 291 P.2d 216) (1955), the AZ Supreme Court ruled that residential developers were not taxable as contractors if they had not contracted with others to build the homes, even if they entered in a sale agreement before completion of a home.
- The Court also ruled that contracting did not include owners who construct buildings on their own property.
- This decision was reaffirmed in *Arizona State Tax Commission v. Staggs Realty Corp.,* 85 Ariz. 294, 337 P.2d 281 (1959).

1960 – 1979

- In 1968, the AZ Court of Appeals held that a city could not impose its tax on a contractor working for the University of Arizona because any city tax passed through would impose a tax on the state. *Ashton Company v. City of Tucson,*7 Ariz. App. 509, 441 P.2d 275.

- *Ashton* was overturned in 1971 by the Court of Appeals in *City of Tempe v. Del E. Webb Corporation,*14 Ariz. App. 228, 482 P. 2d 477, wherein the court determined that it did not matter that the financial burden of the tax fell on the state.

- The latter decision was consistent with the TPT treatment of contracting projects with the federal government.

1960 – 1979

- Although the scope of the TPT excluded most services, issues arose regarding the taxability of these services when performed in conjunction with taxable activity.

- The first major case to deal with this issue was *Ebasco Services, Inc. v. State Tax Commission,* 105 Ariz. 94, 459 P.2d 719 (1969).

- In *Ebasco,* the contractor had a separate contract for engineering and design services, and the Court determined that those services were not incidental to the contracting services, as the taxpayer had a separate division that performed the services, that such services were not uniformly performed by the contractor on any given project and, as a result, the services were not integral to the contracting business.

- The *Ebasco* case also presented the AZ Supreme Court with the issue as to whether the contractor's purchases of machinery and equipment that would be exempt under the retail classification, on behalf of the owner through the use of an agency agreement, would allow the owner's reimbursement of those costs to be excluded from the contracting tax base.

- In finding for the taxpayer, the Court ruled that there was no change in ownership of the machinery and equipment from the contractor to the owner when purchased under agency and, therefore, receipts from those purchases were excluded from the contracting tax base.

1960 – 1979

- The issue of the taxability of engineering and design services in conjunction with a construction contract was revisited by the AZ Supreme Court in *State Tax Commission v. Holmes & Narver,* 113 Ariz. 165, 548 P.2d 1162 (1976).
- In finding for the taxpayer, the Court established three tests to determine whether such normally exempt activities could be excluded from the tax base of a taxable activity:
  - It can be readily determined which portion of the business is from nontaxable professional services, and
  - The amount of the service is not inconsequential to the total business, and
  - The services are not incidental to the contracting business.

1960 – 1979

- In 1976, the Legislature enacted a land deduction in the contracting classification based on the sale price of the land, not to exceed its fair market value (Laws 1976, Ch. 49).
- The question whether land could be excluded from the contracting tax base for periods prior to the enactment of the land deduction was litigated in *Dennis Development v. Department of Revenue,*122 Ariz. 465, 595 P.2d 1010 (1979).
- In that case, the AZ Court of Appeals determined that the sale of land did not constitute contracting and that the land transferred in a construction project was not part of the tax base.

1960 – 1979

- In an early case dealing with contracting activity on Indian lands, the AZ Supreme Court determined that a contractor engaging in construction activity pursuant to a contract with the Bureau of Indian Affairs was subject to the TPT. *Arizona Department of Revenue v. Hane Construction,* 115 Ariz. 243, 564 P.2d 932 (1977).

- The Court based its decision on the fact that federal regulations did not preclude imposition of the TPT, nor was the tax being imposed on Native Americans, the tribe or their property.

- Subsequent cases have dealt with a broad range of projects, such as reclamation and road construction, on reservations and whether the TPT is precluded because of preemption under the federal regulatory framework for taxation on reservations or the effect of the tax imposition of the tribe or its members.

1960 – 1979

- Laws 1978, Chapter 97 made significant changes to the contracting provisions. Subcontractors were exempted from the tax with proper documentation, and the incidence of the tax fell on prime contractors. The deduction for labor was changed to a straight 35% of the gross income or gross proceeds of sales from the contracting activity.

- “Prime contractor” was defined, in part, as “the contractor who supervises, performs or coordinates the construction, alterations, repair, addition, subtraction, improvement, …, including the contracting, if any, with any subcontractors or specialty contractors, and who is responsible for the completion of the contract.

- Also implemented by this law was the concept of an owner-builder, which was defined as “a person who owns or leases real property within the state, and who acts as a contractor, either himself or through others, in constructing any improvement to real property, which real property as improved is held by such person for his use or rental purposes.”

- An owner-builder who sold its property within 24 months after substantial completion would be treated as a taxable prime contractor. An amendment to this provision in 1984 clarified that only the value of the improvements incorporated within the 24 month period would be taxable as prime contracting. (Laws 1984, Ch. 152)

1980 – Current

- Because the cities operated under separate tax codes from the state, two city cases hold significance.

- *Bassett v. City of Tucson,* 137 Ariz. 199, 669 P.2d 976 (App. 1983) examined whether an owner-builder that utilized contractors for the construction of a shopping center was subject to tax on its gross receipts from the sale of the property a year after completion and whether taxation of that sale constituted double taxation. The court determined that the sale was subject to the City's TPT because the owner had improved real property and there was no double taxation because Tucson allowed a credit to the owner-builder for tax paid to the City by the contractors who worked on the project.

- In contrast, the Court of Appeals looked at the City of Phoenix definition of contractor in *City of Phoenix v. Santa Anita Development,* 141 Ariz. 179, 685 P.2d 1331 (App. 1984) and determined that, while the taxpayer had sold improved real property, the proceeds were not subject to tax under contracting. Unlike Tucson's definition of contracting, the Phoenix code required that a taxable contractor be acting pursuant to a contract.

1980 – Current

- The Arizona Court of Appeals looked to the *Bassett* decision and the differences between the Arizona and City of Tucson TPT codes to determine that, for state purposes, an owner of property could not be taxable as a prime contractor unless it acted as a prime contractor in the development of property. *SDC Management Inc. v. Arizona Department of Revenue, 167 Ariz.* 491, 808 P.2d 1243, 1249 (App. 1991).

- This decision was the basis for an amendment to the state definition of prime contractor in 2007 to specify that a person who owns real property, engages one or more contractors to modify that real property and who does not itself modify that real property is not a prime contractor regardless of the existence of a contract for sale or the subsequent sale of that real property. Laws 2007, Chapter 188. The amendment was retroactive to the date of the *SDC Management* decision.

1980 – Current

- In 1985 and 1986, based on case law and in response to a series of meetings with interested parties, the Department of Revenue issued a series of rulings holding that developers and homebuilders could conduct business in a marketing arm/construction arm structure to put the incidence of the tax on the construction activity rather than the sale price of the property.
- All costs of construction must be included in the TPT tax base of the construction entity, intercompany transactions must be at arms length, and the construction entity must make a reasonable profit under the guidance issued by the Department.

1980 – Current

- In 1987, the cities and towns in Arizona adopted the Model City Tax Code (MCTC) to eliminate the significant disparity among the local codes.
- Due to the presence of 44 local and model options, the MCTC is not uniform, but, in the area of contracting, there is substantial uniformity.
- The MCTC provides for three different classifications of contracting activity: construction contracting, speculative builder and owner-builder.
- For city purposes, an owner-builder is an owner or lessor of real property who, by himself or by or through others, constructs or has constructed or reconstructs any improvement to real property.
- A speculative builder is an owner-builder that sells or contracts to sell at any time homes or improved residential or commercial lots without a structure or to sell other types of improved real property prior to completion or before the expiration of 24 months of substantial completion.

1980 – Current

- In *Brink Electric Construction Co. et al v. Arizona Department of Revenue,* 193 Ariz. Adv. Rep. 56, 909 P.2d 421 (App. 1995), the taxpayer made two significant arguments.
- First, the taxpayer argued that an agency agreement was not necessary to exclude the gross receipts from the purchase of otherwise exempt machinery and equipment from the contracting tax base. The court disagreed.
- Second, based on an existing Department rule, that exempt machinery and equipment had to be permanently attached to real property in order for the activity to be considered contracting. The court disagreed.

1980 – Current

- In response to the *Brink* decision, the Legislature passed Laws 1996, Chapter 319, to allow a deduction from the prime contracting classification for the installation, assembly, repair or maintenance of exempt machinery and equipment that does not become permanently attached to real property.
- Permanent attachment is defined in the statute; however, the interpretation of that definition is currently in dispute and may require legislative clarification.

1980 – Current

- Also in response to the *Brink* decision and the recordkeeping requirements of agency agreements, the Legislature provided a deduction from the contracting tax base for purchases of exempt machinery and equipment, as well as all tangible personal property for nonprofit hospitals and qualifying healthcare organizations. (Laws 1998, Ch. 90)

1980 – Current

- Laws 1998, Chapter 286 additionally exempted the gross income or gross proceeds of sales from the installation, assembly, repair or maintenance of clean rooms from the contracting tax base.

1980 – Current

- In 1995, Governor Symington vetoed SB 1206, which would have repealed the TPT on prime contracting in favor of taxing the purchase of materials for incorporation in construction projects under the retail classification.
- The focus of the veto was the estimate of revenue loss in excess of $50 million annually.

1980 – Current

- In 1998, the Arizona Tax Research Association (ATRA) commissioned an analysis of the revenue impact of shifting the incidence of the AZ TPT from prime contracting to a tax on materials.
- The analysis was completed by the firm Arthur Andersen and issued in February 1999.
- Through an analysis of Census data, other databases, such as those maintained by the University of Arizona, and contractor surveys, the analysis concluded that the state would benefit from a tax on materials due to the time value of money, noncompliance with the contracting provisions and misuse of exemption certificates by contractors when making retail purchases.
- The fiscal analysis issued by the Arizona Department of Revenue indicated a loss to the state, and JLBC issued a neutral impact.

1980 – Current

- Since the ATRA analysis looked at the state impact, the study did not address the impact of the different contracting provisions under the MCTC and the impact to both municipalities and counties in having the tax impact concentrated in the retail centers where materials would be purchased, rather than where the construction occurred.

This summary of the history of the Arizona transaction privilege tax on contracting is not intended to include all legislative enactments, judicial decisions or administrative pronouncements impacting the contracting classifications at the state and municipal levels. Rather, the focus of this summary is to summarize key actions which impacted contracting over time.

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